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STERLING'S WORLD REPORT

The Dollar Drama – Risks and Opportunities

The U.S. dollar has fallen 26% against the euro since its turning point in February 2001. Many investors and traders who did not jump on the trend may feel they have missed the boat.

If history is any guide, however, the dollar drama is far from complete. In fact, we may not have even reached the intermission, as financial history suggests that the dollar may experience further substantial depreciation. Let's look first at past major adjustments in the dollar and then consider the risks and opportunities that are likely if the dollar's downtrend continues.

Money and Politics

As seen on the long-term chart of the trade-weighted dollar (See Chart 1), there have been three major reversals in the dollar over the past few decades: the dollar's rise after 1980, its fall after 1985, and its move up after 1995. These moves have tended to be major affairs lasting several years. In fact, recent research by Deutsche Bank indicates that, since the early 1970s, cycles in the dollar have averaged about seven years.

Why is the dollar's downtrend likely to continue? In our opinion, there are three main reasons: (1) the U.S. trade deficit, (2) weak capital flows, and (3) politics.

The first two factors are closely related. With the U.S. external deficit having reached \$500 billion in 2002, the country needs to attract a net \$1.9 billion of foreign capital every trading day to fund that deficit. That figure is likely to increase this year with the U.S. growing faster than Europe and Japan. That

should cause the U.S. to continue to import large volumes of overseas goods even as U.S. growth remains sluggish. Accordingly, most analysts believe the U.S. external deficit will reach a whopping \$600 billion this year, or nearly 6% of gross domestic product.

However, with the U.S. economy still struggling with excess capacity in many industries following the late 1990s boom, it is not clear that it will be able to produce enough compelling investment opportunities to attract ever larger quantities of foreign capital. This is especially true now that U.S. interest rates are considerably lower than interest rates in many other developed nations, as shown in Chart 2.

To deal with this problem, a much larger fall in the dollar will probably be necessary. As shown in Chart 1, the dollar's recent decline on a broad trade-weighted basis still looks fairly modest from a historical perspective. This reflects the fact that the dollar has not moved at all against some fixed currencies with a large weight in the U.S. trade deficit.

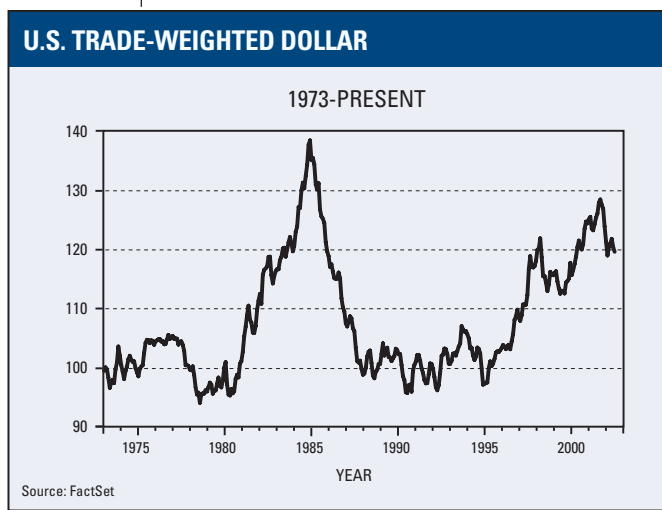


Chart 1: From a historical perspective, the decline in the U.S. trade-weighted dollar has been modest so far – but major reversals have typically lasted for a number of years.



The Dollar Drama – Risks and Opportunities *(cont'd)*

China's currency, the renminbi, is an important case in point.

According to recent calculations by the U.S. Federal Reserve, a 10% fall in the trade-weighted dollar is required to reduce the external deficit by 1% of GDP. That suggests that the trade-weighted dollar may have to fall by as much as 30% to cut the external deficit in half, to a more sustainable level. That won't happen overnight, and will be fiercely resisted by Asian central banks, like the Bank of Japan and the Bank of China, which

do not want to see a decline in their export competitiveness.

That brings us to politics. The Bush administration is extremely sensitive to the widely held view that George Herbert Walker Bush lost the 1992 election because he didn't pay enough attention to the economy after having won the Gulf War. Accordingly, George W. Bush appears determined to both win another Gulf War and to ensure the economy is growing nicely in time to make a difference in the 2004 presidential election.

international gold standard was coming under speculative attack. Interrupted by his Treasury secretary, who was concerned about the ripple effects of a crisis in the Italian lira, Nixon reportedly said something like "forget the lira," but in less polite language. George W.'s language may be more polite than Nixon's, but his political advisers' intense focus on using economic policy to win the next election is not in doubt.

Risks of a Weak Dollar

There is frequently a lot of semi-hysterical commentary about currency movements that, in our opinion, typically does not stand up to careful analysis. Will a weak dollar bring back inflation in a major way? We doubt it. In fact, there is some reason to believe that in a world with a great deal of excess capacity, the negative impact of a weaker dollar on Japan and the euro area will outweigh the positive effect on the U.S., leading to stronger deflationary pressure.

The offset, which we think is highly likely, is that Europe will be forced to cut interest rates substantially. Japan, which already has zero interest rates, will be forced to adopt other measures such as more aggressive "quantitative easing" (printing money) or more aggressive

Starting in mid-2001, a large number of U.S. firms began complaining that the dollar's strength is harming manufacturing exports, production and employment. If a weaker dollar can help offset this trend, even if it comes at the expense of European and Asian competitors, the Bush administration is unlikely to oppose further dollar weakness. It may not actively call for dollar weakness for fear of spooking financial markets. But a policy of "benign neglect" – saying nothing while market forces bring the dollar lower – would probably suit its political needs just fine.

We are reminded of a famous story about Richard Nixon, who was focused on domestic politics in the early 1970s at a time when the

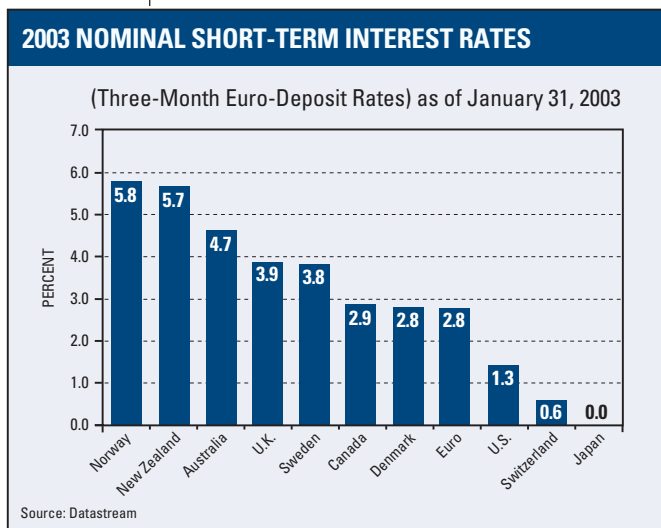


Chart 2: U.S. short-term interest rates were 6% in early 2000, but are now among the lowest in the world. This is a key factor contributing to dollar weakness.

The Dollar Drama – Risks and Opportunities *(cont'd)*

fiscal expansion, or both. Effectively, therefore, a weak dollar could prompt Europe and Japan to boost their economies and fight deflation more aggressively.

How have stocks and bonds fared in the past during periods of dollar weakness? Somewhat

surprisingly, the correlation between the dollar and stock and bond returns has been close to zero since 1973, when the dollar began to float freely. That is, even if a clairvoyant told you exactly what the dollar would do over the next few quarters, it generally would have been almost useless for predicting stock and bond returns.

typical returns of 2.2% per quarter over the 1973-2002 period, bonds experienced total returns of 5.6% on average during the weak dollar periods. That probably reflected the fact that U.S. policymakers typically did not let the dollar fall if they thought inflation pressures were mounting.

That said, if we limit ourselves to looking at how the dollar fared *during* and *immediately following* big drops, we can make several observations.

Table 2 looks at how stocks and bonds fared in the quarter following a big dollar decline. This should be highly relevant to investors today, since the dollar has experienced a 5% trade-weighted decline over the three months to January. Interestingly, stock returns were positive 80% of the time in the quarter following a big dollar decline, with average gains of 3.6% per quarter or about double the historical average. Bond returns of 2.1% were slightly below the historical average, but not meaningfully so.

As shown in Table 1, U.S. stock prices had a median return of 6.1% during the 10 largest quarterly declines in the trade-weighted dollar, or much more than the average quarterly return of 1.8% over the entire 1973-2002 period. That said, average quarterly return was only 1% during those periods, reflecting the influence of the 1987 stock market crash. Sixty percent of the time, the stock market went up when the dollar went down. That pattern probably reflected expectations that dollar weakness would boost profits for U.S. corporations with overseas earnings.

One qualification: There is some evidence that stock market volatility has been higher than average in the quarters following big declines in the dollar. Normally, that would be a negative, since investors dislike uncertainty. But as can be seen in Table 2, most of the volatility for stocks following big dollar declines has been upside volatility. And that is the kind of volatility investors and incumbent presidents typically like to see.

Somewhat surprisingly, U.S. bond returns were quite positive during periods of pronounced dollar weakness. Compared to

U.S. Financial Market Performance Associated With the 10 Largest Quarterly Declines in the Trade-Weighted Dollar

Quarter	Previous Quarter's Dollar Decline	Change in S&P 500	Total Return on U.S. Treasuries
	%	%	%
Q4-1987	-5.3	-28.0	7.8
Q2-2002	-5.0	-12.9	5.5
Q1-1987	-5.0	16.2	-0.2
Q4-1985	-4.7	11.9	11.5
Q4-1988	-4.7	3.1	0.3
Q2-1980	-4.7	9.0	19.7
Q1-1986	-4.5	11.4	13.5
Q3-1990	-4.4	-13.3	-0.6
Q4-1977	-3.9	-2.5	-0.8
Q1-1998	-3.7	15.4	-0.4
Average	-4.6	1.0	5.6
Median	-4.7	6.1	2.9
Up vs Down Quarters	0/10	6/4	6/4
Compare:			
1973-2002 Average	0.2	1.8	2.2

Table 1: U.S. stocks and bonds have moved up 60% of the time when the dollar has experienced large declines, but the range of returns has varied considerably.

The Dollar Drama – Risks and Opportunities *(cont'd)*

Opportunities in a Weaker Dollar

We think the evidence is fairly clear that major dollar reversals in the past have not brought Armageddon in the stock and bond markets. If anything, having just been through stock market Armageddon, investors could

well find a weak dollar to be part of a reflation strategy associated with market revival rather than further declines.

There are a number of ways to profit from a dollar decline. Owning bonds in the “Eurozone,” Britain, Scandinavia and Switzerland should continue to be profitable since that is where we expect dollar weakness to be most pronounced. As noted earlier, Asian central banks are likely to resist appreciation in their currencies, so the area of least resistance is likely to be Europe. The purest play on this theme within the funds that we manage is the CI Global Bond Fund, which enjoyed robust double-digit returns last year and is positioned to benefit from further appreciation of the euro and other European currencies.

Within the global equity markets, there are four areas we would highlight as benefiting from a weaker dollar:

- European companies that distribute domestically but whose costs are in U.S. dollars;
- European companies that will benefit from lower interest rates;
- U.S. exporters;
- Emerging markets whose currencies are linked to the U.S. dollar.

We continue to analyze how currency issues will affect the companies we hold in our global equity portfolios, and are emphasizing companies that have attractive bottom-up fundamentals that may also benefit from dollar weakness. We are also hedging a substantial amount of U.S. dollar currency risk out of our portfolios. That takes advantage of the fact that the cost of hedging is cheaper than in many years thanks to low U.S. interest rates.

As the *Financial Times* recently noted, “for investors worldwide the fall in the dollar will continue to be both an opportunity and a risk.” In our funds, we are focused on seizing the opportunities while managing the risks prudently. We believe that capitalizing on this trend will be key to investment performance for some time to come. If we are correct, the dollar drama will not be a one-act play and may well experience a long run.

*William Sterling, Global Strategist
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U.S. Financial Market Performance Following the 10 Largest Quarterly Declines in the Trade-Weighted Dollar

Quarter	Previous Quarter's Dollar Decline	Change in S&P 500	Total Return on U.S. Treasuries
	%	%	%
Q1-1988	-5.3	9.8	3.9
Q3-2002	-5.0	-15.6	10.5
Q2-1987	-5.0	3.0	-4.2
Q1-1986	-4.7	11.4	13.5
Q1-1989	-4.7	5.7	1.2
Q3-1980	-4.7	9.9	-9.1
Q2-1986	-4.5	5.4	2.2
Q4-1990	-4.4	4.1	7.3
Q1-1978	-3.9	-5.5	-0.6
Q1-1999	-3.7	7.4	-3.3
Average	-4.6	3.6	2.1
Median	-4.7	5.6	1.7
Up vs Down Quarters	0/10	8/2	6/4
Compare:			
1973-2002 Average	0.2	1.8	2.2

Table 2: U.S. stocks have experienced above-average returns in the quarter following large dollar declines.